

Defining Materiality and Reportable Conditions

Revised OMB A-123

Revised OMB A-123 Requirements

- Changed the title to emphasize Internal Control is **Management's Responsibility**
- Effective FY 2006
- Updated Internal Control Standards
- Requires an integrated internal control framework
- Introduced Reportable condition as a category of deficiency
- Requires CFO Act agencies to include the FMFIA annual report in the PAR
- Requires separate assurance statement on the effectiveness of internal control over financial reporting
- Added Appendix A: Internal Control Over Financial Reporting to identify the requirements for conducting management's assessment of the effectiveness of internal control over financial reporting

Internal Control

- Management responsibility to establish and maintain internal control
- Internal control objectives:
 - Effective and efficient operations
 - Reliable financial reporting
 - Compliance with applicable laws and regulations

Safeguarding of assets (subset of 3 main IC objectives)
- Apply to program, operational, administrative, accounting and financial management
- Should be integrated with planning, budgeting, management, accounting, auditing and into each system
- Appropriately balanced with risk so that benefits (qualitative & quantitative) outweigh the costs of implementing the control

5 Components of Internal Control

- **Control Environment**

- Organizational structure & culture to support effective internal control

- **Risk Assessment**

- Identify internal and external risk that may prevent an entity from meeting its objectives

- **Control Activities**

- Policies & procedures to ensure agency objectives are met

5 Components of Internal Control

(Cont'd)

- **Information & Communication**
 - Information should be communicated to personnel at all levels within an agency & should be relevant, reliable, and timely
- **Monitoring**
 - Monitoring of the effectiveness should occur in the normal course of business

Appendix A: Internal Control Over Financial Reporting

- Applicable to the 24 CFO Act agencies
- Establishes a requirement for a **management assessment** process and provides a methodology for the assessment
- Requires process & methodology to be **documented**.
- Defines materiality for assessing and documenting internal control over financial reporting
- Requires management to use a separate materiality level to assess financial reporting controls
- Requires a **separate assurance statement** on the effectiveness of internal control over financial reporting

Overall Objective & Scope of Internal Control Over Financial Reporting

- To provide reasonable assurance regarding reliability of financial reports
 - Existence & Occurrence
 - Completeness
 - Rights and Obligations
 - Valuation
 - Presentation & Disclosure
- Safeguarding of assets & compliance with laws and regulations relating to financial reporting

Definition of Financial Reporting

- Annual Financial Statements
- Other significant internal or external financial reports
- Each agency should determine which financial reports are significant
- What reports are significant?
 - Material effect on spending, budgetary, or other financial decisions
 - Used to determine compliance with laws and regulations

Materiality for Financial Reporting

- **A-123 Definition:** Risk of error or misstatement that could occur in a financial report that would impact management's or users' decisions or conclusions based on the financial report
 - Planning Materiality
 - Lower threshold than *Reporting Materiality*
 - Designed to ensure that items required to be reported will be detected
 - Reporting Materiality—Determining the deficiencies that should be reported by management

Categories of Control Deficiencies

- Control Deficiency
- Reportable Condition
- Material Weakness

*Important to understand these terms
before discussing materiality*

Control Deficiency

- Design or operation of a control does not allow misstatements to be prevented or detected on a timely basis
- Missing control
- Improperly designed control
- Control does not operate as designed
 - Ineffective performance of the control (employee qualifications or skills)

Reportable Condition

- One or more control deficiencies
- Adversely affects ability to initiate, authorize, record, process or report external financial data reliably in accordance with GAAP
- Good possibility that a misstatement will not be prevented or detected
 - affects the financial statements or other significant financial reports
 - More than inconsequential

Should be reported internally & corrective actions tracked

Material Weakness

- One or more reportable conditions
- More than a remote likelihood that a **material** misstatement will not be prevented or detected
- Included and separately identified in the annual FMFIA report (External Reporting)

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 - Reporting Materiality—Determining the deficiencies that should be reported by management
 - Agency Divisional/Component managers should use the *Reportable Condition* definition in determining what to report to Agency management
 - Agency management will determine if reportable conditions should be included as a material weakness to report to DoD

Specific Materiality You Should Use

- **Good News:** There is no magic materiality percentage that you must use
- **Bad News:** A-123 wants Management and IC personnel to use their judgment
 - Judgment is subjective
 - An auditor will probably second guess your judgment
 - You must document the rationale for your judgment
- **Factors to Consider:**
 - Qualitative as well as quantitative measures
 - Materiality may differ from report to report
 - Intentional misstatements are normally serious even if not considered material

What Materiality Do Auditors Use?

- **Audit definition:** An omission or misstatement of an item in a financial report that would make it probable that the opinion of a reasonable person relying on the information would have been influenced or changed.
 - **Translation:** *Any error that might cause someone to come to a wrong conclusion*

What Materiality do Auditors use?

- **Guidance in the Financial Audit Manual (FAM)**
 - **Identify Materiality Base** (FAM 230.08)
 - Element of the financial statements that is most significant to the primary users of the financial statements
 - Use judgment to determine the appropriate element of the financial statements to use as the materiality base
 - In DoD Agency-Wide audit, we take total assets less Intragovernmental assets
 - FAM suggests using separate materiality base for intragovernmental balances.
 - For the SBR we will probably use *Total Budgetary Resources*

What Materiality do Auditors Use?

- **Auditor Planning Materiality** = 3% of Materiality Base
 - This is a preliminary estimate of the maximum total errors in the financial statements taken as a whole that could make them unreliable
 - This could be a combination of smaller errors
- **A-123 Materiality**—Roughly equivalent to *Reporting Materiality*

What Materiality do Auditors Use?

- **Auditor Design/Test Materiality = 1%**
(or approximately 1/3 of Auditor planning materiality)
 - Starting point to design procedures to testing line items to detect an aggregate material misstatement
 - If any error or combination of errors add up to the test materiality for a line item, we *may* consider the line item as materially misstated
- **A-123 Materiality:** Roughly equivalent to *Planning Materiality*

Internal Control Assessment and Reporting Process

- Senior Assessment team should be established
- **Responsibilities:**
 - Ensure objectives are communicated and understood throughout the agency
 - Ensure effective assessment is completed within required time frames
 - Determine significant financial reports to be covered by the assessment
 - Approving the design and methodology of assessment

Internal Control Assessment and Reporting Process

- Identify significant external and external reports
- Determine significant accounts or groups of accounts that support those reports
- Identify major classes of transactions that materially affect those accounts
- Understand the reporting process

Internal Control Assessment and Reporting Process

- Gain an understanding of controls designed to achieve management's assertions (Walk-through)
- Test controls that appear to be effective to determine if they are consistently applied
- Make overall conclusion regarding the effectiveness of internal controls over financial reporting
- Prepare annual assurance statement on internal control over financial reporting

Conclusion from Auditor Perspective

- Materiality for Internal Control assessments does not have to be the same as auditor materiality
- When auditors review what management has done, they will want to see **Documentation** of
 - Key decisions by assessment team
 - Methodology used to perform assessment
 - What testing was actually performed
 - Specific problems/deficiencies identified
 - Plans for corrective action
- A-123 does not require auditors to give a separate audit opinion on Internal Control. However we are required to report on the effectiveness of Internal Control

Implementation Guidance

- OMB plans to issue an implementation guide for applying Appendix A to the major Federal agencies in March 2005
- I expect DoD to issue guidance to address implementation and reporting requirements for DoD activities not required to compile financial statements